Global markets nervous about China's mounting debt

John Chan
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In an effort to address growing international concerns over the huge debts accumulated by China's local governments, the national audit office last week published its first-ever audit of their finances.

In late 2008, in response to the global financial crisis, Beijing resorted to a 4 trillion yuan ($US620 billion) stimulus package. Local governments were able to set up investment companies and aggressively borrow from state banks at low interest to build infrastructure and real estate projects.

As a result, according to a recent Credit Suisse study, Chinese banks issued credit totalling $2.7 trillion in 2009 and 2010. As Beijing has tightened credit, the lending slowed sharply in the first five months of 2011, but still reached $556 billion.

The national audit office said the total debt incurred by local governments by the end of 2010 was 10.7 trillion yuan or $1.65 trillion. About half ($767 billion) was held by local government-backed investment companies. Provincial, municipal and county governments had set up 6,576 financing vehicles, of which 358 had obtained further loans to cover expiring ones and 148 had defaulted.

An American political scientist, Northwestern University's Victor Shih, has dismissed the national audit office's finding because it only counted loans explicitly guaranteed by local governments, not those backed by state land and other state assets as collateral. He estimated that China's actual debt to gross domestic product (GDP) ratio could be well over 150 percent, far higher than the official 27 percent.

Credit Suisse analyst Victor Chen warned last month: "China's credit-to-gross domestic product ratio has risen to alarming levels in the past two years due to massive off-balance-sheet financing, and raised a red flag for future asset quality problems in banks." Wang Tao, the chief China economist at UBS, predicted earlier last month that local government investment companies could produce non-performing loans worth as much as $460 billion in the next few years.

Fuelling the concerns are signs that the over-heated property market is heading for a major downturn. A sharp drop in property prices would seriously impact on local governments, which depend on land sales as a major revenue source.

Real estate prices had soared partly because industrial companies, seeking to offset lower profits, also channelled funds into property speculation. Prices reached such an absurd level that last year's total land values in Beijing alone exceeded the GDP of the US, which is 2.5 times greater than China's.

Subsequent measures to tighten bank lending led Standard & Poor's to downgrade the outlook for China's property sector to "negative" in mid-June. S&P analyst Bei Fu told the *Financial Times*: "In the near term, what worries us most is the liquidity position of developers, who are facing very tight lending control. In this situation developers really need to rely on their own sales but this is a highly uncertain prospect given government attempts to suppress the market and the fact sales volumes have already started to come down."

Moody's also cut its outlook for Chinese property developers from stable to negative in April. Moody's predicted that the sales volume in big cities this year could see a 25-30 percent fall, even as most developers planned to boost sales by 20-40 percent. S&P warned that the resulting oversupply could generate a "price war" among developers.

Nicolas Lardy, an American expert on the Chinese economy, who earlier dismissed the notion of a property bubble, changed his mind last month, predicting that China was heading for a "major, major economic correction."

At the root of the crisis is China's role as a global cheap labour platform. Low wages for workers mean that domestic consumption accounts for a very small share of GDP. Capital investment provides close to 50 percent of GDP. The enormous and rising output must be exported, especially to Europe and the US.

Even before the global financial crisis, overcapacities plagued many industries. While an estimated 110 million members of the Chinese middle classes constitute the world's largest car market, for instance, they account for only 8 percent of the country's population and their total purchasing power is only 6 percent of the American consumer market.

Standard Chartered economist Stephen Green recently estimated that half the Chinese GDP is now linked to the real estate market, including the construction, steel, concrete, power and home appliance industries. Because of the slowing property market, manufacturing barely grew in June. Credit Suisse now predicts next year's GDP growth will be just 8.5 percent, down from 9-10 percent this year.

There is deep fear in Beijing's ruling elite that the worsening financial turmoil in Europe will unleash economic instability in China, given that Europe is China's largest export market, and Beijing holds euro-denominated assets worth 600 billion euros. Seeking to assure European political and business leaders of China's economic strength, Premier Wen Jiabao toured Hungary, Britain and Germany last week. In a *Financial Times* article, Wen wrote: "There is concern as to whether China can rein in inflation and sustain its rapid development. My answer is an emphatic yes."

Talking to a group of Chinese students in the UK, however, Wen admitted that social unrest was a major threat: "My experience is that if inflation goes with corruption, they could undermine a regime's stability and a society's harmony." Wen previously admitted that it would be hard to keep inflation under 4 percent. The consumer price index reached 5.5 percent in May—the highest in 34 months—with food prices up by over 11 percent in a year.

Wen, who was a central government official in 1989, knows that the initial student protest opened the door for a mass movement of the working class angered by hyperinflation and rampant official corruption. He was part of the Stalinist regime that crushed the movement with tanks and troops in Tiananmen Square and police state repression in other cities.

Many in global financial circles remain anxious about the recent protests of migrant workers, who clashed with riot police in Zengcheng, and signs of a new wave of strikes among factory workers. Moody's Investor Service stated last month: "We do not see negative credit implications from the recent unrest because it has remained localised." Then it added: "What we do see are clouds gathering on the economic horizon at a time when social unrest is apparently rising."

All the signs are that the Chinese regime is sitting on a social time bomb, which could be triggered either by slowing economic growth or a new global financial meltdown. While the exact forms of the eruption cannot be predicted, it will certainly involve the country's multi-million working class that has grown immensely since 1989.